Revised September 20, 2002

<center>

Armenia Pension Reform Assessment
By Denise Lamaute, Senior Pension Reform Advisor
Assessment was conducted in Armenia July 12-23, 2002

</center>

INTRODUCTION

The goal of USAID/Armenia 's pension reform program, which is one of several significant areas covered under a substantial social-sector reform effort that began in August 2000, is to reduce poverty among the elderly for several generations to come within a fiscally sound and sustainable pension system. This is a daunting challenge considering that the economic, demographic and geo-political conditions in Armenia have faced enormous challenges over the last decade and resultantly, poverty has increased not just for the elderly, but for the Armenian society as a whole. Nevertheless, USAID/Armenia has been successful in placing meaningful pension reform building blocks in place that should help Armenia develop a healthy and viable pension system, over the long-term.

The goals of the pension reform aspect of USAID/Armenia 's Social Transition Program (STP) as provided by USAID contractor, PADCO, are to:
* Improve the legal and regulatory framework so that the pension benefits in Armenia are adequate for retirees while the fiscal impact of pension expenditures on the budget is reasonable and sustainable, and
* Strengthen the institutional capacity of the pension providers, public or private, to ensure that pensions are regulated and managed efficiently and effectively.

Within this context, critical aspects of the pension reform such as developing or improving the information technology delivery systems and providing a major public education program are necessary for the success of the pension reform.

The primary focus of the pension reform technical assistance effort, thus far, has been to make the 1st pillar publicly mandated Pay-As –You-Go (PAYGO) system more efficient. The reason for this is two-fold: 1) from a policy perspective, the pension benefit from the PAYGO is far too low

<center>1</center>

to provide a reasonable standard of living for the elderly; and 2) from an administrative perspective, the pension system does not operate according to international standards nor does it utilize best practices to enable it to deliver high quality social protection services. To that end,
USAID/Armenia is assisting the government of Armenia (GOA) develop the analytical tools and capabilities to enable it to develop better pension policies. It is also providing training and technical support to help the GOA upgrade its IT systems and its human resources capacity.

However, the declining economic situation in Armenia has caused and continues to cause a heavy strain on the pension system. The Armenian pension benefit is woefully inadequate with most pensioners receiving less than $10 per month, roughly 23% of the average salary and about 50% of the Armenian government poverty level.

The pension expenditures equal about 2.8% of Armenia's GDP. The pension system has eliminated its pension deficit and expects to begin accumulating a surplus over the next few years. However, while a surplus pension can be viewed as financially positively, the very low pension benefit in Armenia detracts heavily from this good news.

The unemployment rate in Armenia is estimated at between 10% officially and 25% unofficially. Armenia also has an aging population and a steady out-migration of the working age population. Thus, it is easy to grasp the fact that the pensioner population of 582,000 is larger than the number of those who contribute to the pension system, about 414,000, according to Armenia's State Fund of Social Insurance (SIF), the GOA's social insurance agency.

In addition to the economic and demographic pressures on the pension system, the administrative inefficiencies of Armenia's pension system are another major issue. Little or no automation of the pension systems seems to be the biggest problem. From anecdotal information primarily, the pension system's administrative and operational functions are very bad.

The silver lining among the tremendous challenges to reforming Armenia's pension system is the *increasing commitment from the government of Armenia* (GOA) to tackle a vast set of economic, judicial,

and social sector reforms. These planned reforms coupled with an optimistic economic outlook are, in essence, necessary to advancing Armenia's pension reform agenda.

Another positive aspect of the pension reform is the favorable demographics expected in the next 15 years. Because birth rates were low during World War II and the retirement age is expected to increase between now and 2011, few new retirees are expected until about 2011. However, while the favorable demographic picture helps to stabilize the pension liability side of the equation, the shrinking number of working contributors to the pension system due to high unemployment and the large shadow economy greatly undermine the stability of the pension system. Consequently, *a stable and growing economy with a shrinking shadow economy is needed for a successful pension reform in Armenia.*

THE CURRENT PENSION SITUATION IN ARMENIA

Armenia has a single-tier public pay-as-you-go (PAYGO) pension system that provides, for the most part, a very low flat benefit. Armenia's pension system is more akin to a massive social assistance program in many respects. The direct relationship of wages, contributions, and years of service to the retirement replacement wage as a pension benefit is grossly distorted on several levels. For example, retirees may receive a "pension" without any years of service or contributions to the system, which seemingly encourages contribution evasion.

Not all "pension payments" are for pension benefits. Payments are either employee benefit payments, such as the employee funeral benefit, or they are really social assistance related expenditures. Even when pensions are paid based on some work history; the actual pension benefit is not tied to a worker's actual years of service or his actual contributions paid into the system.

Without question, the pension system in Armenia is in very poor shape. The pension benefit in Armenia is extremely low. The replacement ratio is low. Numerous privileged pensions (see details below) bloat the system. Social insurance payroll tax evasion is widespread and is generally thought to exist due to the administrative and operational inefficiencies of the pension and tax collection systems. To what extent such inefficiencies exist within the pension and tax system was not really determined during this cursory assessment. However, there were strong expressions from several stakeholder camps that the design and

administrative operations of the pension system do not serve the best interests of Armenians.

If Armenia is to have a fiscally sound and sustainable pension system that provides an adequate income for retirees for several generations, then some very basic changes should be made to the Armenian pension system, some of which are under consideration in the proposed pension reform law. For example, the retirement age of 63 for men and 58 will be raised to age 63 for both men and women under the pension reform law that is expected to be enacted this fall. The high social insurance payroll tax rate compared to the paltry pension benefit should be restructured. More effective compliance and enforcement measures should be instituted, but within conjunction with an integrated governmental approach to tax collection and compliance.

Low benefit *The* goal of fiscal stability and sustainability and enhanced institutional capacity for the Armenian pension system unquestionably must be done in conjunction with **providing an adequate income for the Armenian retirees.** This latter premise we must not lose sight of. Thus, the $10 average monthly retirement benefit, which is far below the poverty level, should be adjusted upward over time so that it will provide a retirement income, which at a minimum, is above the poverty level.

Replacement Ratio Pension experts suggest that retirement income should equal between 60% and 80% of one's wages just prior to retirement, called the replacement ratio, to maintain a reasonable standard of living throughout the retirement period. While such a replacement ratio target is far greater than Armenia's current 23% replacement ratio and may be deemed unrealistic for the struggling Armenian public pension system at this time, a combination of a public and private pension system should be considered in order to reach a higher replacement ratio target for Armenia's retirees over the long-term. On the other hand, in the absence of a viable capital markets, a private pension system along side a government run pension scheme is also probably a longer-term option for a number of reasons such as low wages, high unemployment and few, if any, investment securities. In addition, were private pension funds introduced as is contemplated based on a currently circulating draft private pension fund law, the GOA may have to decide whether it will allow such private pension funds to invest offshore. The domestic versus foreign investment mix for newly established private pension funds tends to be a healthy debate in most

developing and transitional economy countries. We can surmise that in Armenia such a debate will be no exception on this issue either.

Privileged pensions The privileged pension component of the Armenia pension system increases the financial burden on the pension system and the government, and thus, it should be eliminated. As in most former-communist countries, Armenia being no exception, certain groups of workers are provided a more generous pension at an earlier retirement age. Larger pensions for longer periods of time for a select few jeopardize the fiscal soundness of a pension system, here again, Armenia being no exception.

According to estimates provided by PADCO, Armenia has 83,552 workers who are entitled to receive privileged pensions. Pensioners receiving privileged pensions in July 1, 2000 equaled 18.23% of all old-age pensioners. For males, privileged pensioners were 13.89% of all old-age pensioners, and for females, 20.28%.

Privileged Pensions as of July 1, 2000.	Male	Percent	Female	Percent	Total	Percent
Old-age	112,822	86.11%	221,603	79.72%	334,425	81.77%
Privileged	18,195	13.89%	56,380	20.28%	74,575	18.23%
Total	131,017		277,983		409,000	
				% privileged	18.23%	
Source: PADCO **REPORT No 53** ANALYSIS OF IMPLICATIONS OF TRANSFERRING COSTS OF PRIVILEGED PENSIONS TO EMPLOYERS						

Armenia's bloated privileged pension component should be eliminated and replaced with a more equitable and transparent pension scheme. In essence, all workers should receive a replacement wage based on contributions paid into the system on their behalf during their work history in an across the board and reliable manner.

`Administrative and operational inefficiencies`
The pension system in Armenia is administratively and operationally inefficient. Social insurance payroll tax collection is poor, individual accounts do not exist, and benefit distributions are made on a labor intensive and potentially dangerous door-to-door manner. It is estimated that uncollected pension contributions are at least $60 million due to the shadow economy and poor tax collection, about to the size of the Social Insurance Fund (SIF)'s annual budget.

Separate contribution rates and separate fund accounting do not exist for pensions, occupational disabilities, short-term disabilities and unemployment insurance. A contribution rate for each type of social insurance benefit based on reliable analysis should be imposed to make each fund self-sustaining. Timely, reliable and transparent accounting for each social insurance fund should also be mandated. The benefit formula should be institutionalized so that it is based on reliable and measurable factors and not be left to the whims of the politicians.

Currently, the government of Armenia does not record contributions on an individual account basis, one of the basic requirements of a pension system in order to calculate and pay pension benefits. Employers pay contributions based on gross wages without identifying for whom the contributions are made. As such, the Social Insurance Fund (SIF) does not have reliable data on how much has been paid into the pension system for whom.

Pensions should eventually be based on the years of service and contributions actually paid into the system, which is not the case currently. Most pensions are paid without regard to the direct work history and contributions paid into the system for a particular individual. Such impreciseness tends to encourage fraud and abuse of the pension system.

With the assistance of USAID, workers will receive individual identification numbers, under the PN Program, and eventually have individual social insurance accounts. Under this unique identification system, wages, contributions and other pension related data would be recorded on an individual employee basis. An individual accounts pension system should provide transparency and better oversight and administration of the pension system and thus, increase compliance for the pension system, in the long run. It should also engender greater public support, as workers will be able to monitor their pension accounts.

A PN pilot program has recently been instituted in Abovian. The Minister of Social Security has expressed the desire to have the PN program implemented nationally within the next two to three years.

USAID/Armenia 's commitment to provide $1.3 million in computers and related support equipment for the nationwide implementation of the PN program will go a long way in advancing the automation of the pension

system in Armenia. Nevertheless, USAID/Armenia should be particularly concerned about whether the government of Armenia has the financial resources to maintain and upgrade these computers, its overall IT systems and various other automated aspects delivered under the STP.

If the GOA does not make the financial and human resource commitment to maintaining this PN program and other important infrastructure technical assistance provided by the international donor community, USAID's efforts could be seriously jeopardized.

Payroll tax evasion   The shadow economy, which is difficult to quantify, does not contribute to the pension system. According to the Ministry of Social Security, between $60 and $80 million in pension contributions are evaded due to the shadow economy and tax collection inefficiencies. The pension system should, however, collect contributions from all employers and workers, including those who are self-employed and those who work within the shadow economy. Without a stronger tax and enforcement system, the pension reform will be severely undermined and it is unlikely that the Armenian pension system will become **fiscally sound and sustainable with a higher benefit payout.**

Pension contributions should be collected in full and in a timely manner. As such, a vigorous campaign should be undertaken by the GOA to improve the pension system's social insurance contribution collection and compliance functions. Specifically, the tax collection and enforcement capacity of the Armenian pension system should be strengthened to ensure that it operates according to international standards and best practices.

`Integrated tax collection system` An integrated tax collection system should be considered as a means to increasing the efficiency of all revenue collections, reducing the duplication of activities among various government agencies and deploying limited resources more economically. Both the Ministry of State Revenues (MSR) and the SIF should not both be in the business of collecting taxes when one truly efficient organization can do it for a small country like Armenia. Also, the employer tax administrative filing burden should be reduced if fewer reports are required to be filed with just one government agency.

Considering that a tax administration technical assistance project is underway, it may behoove USAID/Armenia to extend the work of the tax program to include collecting and enforcing the social insurance payroll tax contributions (pension, health and other social sector contributions). At a minimum, the tax collection system and the various databases should have the capability to be integrated, if not at this stage of development, at least at some time in the future.

NOTE: The GOA is aware of the benefits of integrating its tax collection systems, but seems to have opted for a go-slow approach to this issue.

ACHIEVEMENTS TO DATE

At this time, the pension reform effort is concentrating on making the 1st pillar pension scheme, the publicly mandated PAYGO system, more efficient. This is being done with the introduction of draft pension laws that will change a number of fundamental aspects of the pension system, the development of an actuarial office within the government that will aid the GOA in developing the analytical capacity to make more reasoned policy decisions, and the development of a cadre of pension experts to advance the pension reform.

In this year alone, several major pieces of legislation have passed the first reading of Parliament. For example:

The Personal Number (PN) Law in May 2002 by a vote of 70-2,

The Pension Reform Law in June 2002 by a vote of 96-0, and

The Personal Data Privacy Protection in June 2002 by a vote of 59-2.

These votes, which demonstrate strong support for these reforms, provide clear evidence of meaningful consensus building among the various political parties and factions within Armenia that USAID/Armenia and its contractor, PADCO, have managed to achieve. All parties are to be commended for these difficult but successful tasks, to date.

Enhanced information technology systems, including newly designed software programs, are being introduced within the MSS and SIF. For example, the PN program mentioned above should help Armenia provide better quality social services in a more efficient manner. Also, USAID/Armenia is helping the GOA link the main office of the SIF with its local offices, here again, to gain greater efficiency in delivering social services.

Eventually, Armenia plans to have a private pension fund industry to complement its PAYGO scheme. In anticipation of this new industry, USAID is assisting the GOA develop the legal and regulatory framework for private pension funds, as well.

Other achievements within the pension reform subset of the overall social protection program include a public education campaign for policy makers, journalists and the general public that is explaining the need to reform the pension system, actuarial training, and pension modeling training.

CHALLENGES TO PENSION REFORM IN ARMENIA

- **Adequate Income for Retirees –** The pension benefit in Armenia is too low and should be increased at least to equal the poverty level. A retirement replacement wage below the poverty level for the elderly is unacceptable.
- **Infrastructure Capacity Building** – A significant investment in state-of-the-art information technology systems and more efficient and effective management and administration systems are needed for the pension system in Armenia. Human resource capacity building of the pension administration staff, coupled with upgrading the skills of the tax collectors, should receive greater emphasis.
- **Sufficient Financial Resources for Maintenance and Upkeep** – The GOA must make the financial commitment to maintain and enhance the structural and operational changes that USAID and other international donors are providing.
- **Integrated IT** – The GOA should consider integrating its computer operations to a much greater degree than is being contemplated to avoid a duplication of effort and unnecessary IT costs. Employee and employer data should **not** be collected, stored and maintained by a variety of agencies when one data collection point can suffice.
- **Integrate and Strengthen the Tax Collection and Enforcement Functions -** One strong tax collection and enforcement agency should be considered. The pension reform will be undermine and the system will never be fiscally sound or sustainable with an adequate pension benefit if pension contributions are not collected in full and in a timely manner. As such, a vigorous campaign should be undertaken to improve the contribution collection and compliance aspect of the pension system.

OTHER INTERNATIONAL DONORS

USAID/Armenia is the major pension reform technical assistance provider in Armenia. The World Bank has provided pension reform technical assistance – unique identification system development, draft laws, training – however, at this time, it is not providing any significant pension reform technical assistance.

FOR CONSIDERATION

1. What is the **capacity of the SIF**? Put simply, how efficient and effective is SIF? USAID does not appear a have a definitive answer to this question even though the SIF is the primary delivery agency for social protection services in Armenia, excluding health-related services.

   Studies have shown that productivity improvement tends to come almost entirely from the more effective use of people. Of course, enhanced management tools and sufficient and reliable operational systems are also necessary. Is the SIF capable of making the most effective and efficient use of its people and its resources to meet the social services needs of Armenia today and tomorrow? We don't seem to have concrete information to answer this question and, perhaps, USAID/Armenia should ascertain *how capable is SIF,* time and cost permitting.

   USAID/Armenia could consider conducting a management audit of the SIF to establish a baseline of its capacity to deliver the social services that it is required to provide now and in the future. The purpose of such a management audit of the SIF would help to ensure that all their employees, facilities, and business activities are matched with the demands of the agency as it moves toward delivering a full complement of integrated social services. It would also give USAID a useful management tool and, most likely, a better understanding of just how to strengthen the administrative capacity of SIF.

   In essence, we should know the current status of the SIF – its strengths and its weaknesses - to ensure that the SIF, which is the major player in delivering social services in Armenia, develops the sustainable capacity it will need to deliver high quality social services

From the MSI "*Evaluation of the Social Transition Program (STP)"* DRAFT REPORT, September 2002

The **World Bank's activities** have included the following:
-Advised the MOSS concerning the development of a plan for reform of the state pension system, which was reflected in the decree on state pension reform issued in December 1999;
-Supported the development of a personal identification number system, to permit the development of individual pension accounts;
-Assisted efforts to improve the targeting of the Poverty Family Benefit;
-Supported the first household surveys of income and expenditures in 1996, 1998, and 1999;
-Provided assistance to health care reform, including optimization and privatization of health care facilities, reorienting the health care system toward provision of primary health care, training in family medicine, improving management information systems, and planning for the introduction of national health insurance, and
-Funded the Social Investment Fund, which was used for community-based infrastructure projects, similar to projects funded by USAID and implemented by NGOs.
-As of December 31, 2000, the World Bank had extended total credit to Armenia of $607 million, of which $430 million had been disbursed.

within Armenia over the long-term. USAID/Armenia could also use the management audit tool to measure whether the SIF is truly making progress at developing its institutional capabilities and at what rate.

2. Should the pen numbering system (unique identification program) be outsourced for better utilization of PADCO's and the GOA's time and resources? This is probably a moot issue considering that PN software is being developed and a pilot project in Abovian to issue the PN numbers is currently underway.

3. What entity should **regulate the planned private pension funds?** This question, which does not deserve special attention now, may become a hotly contested issue because of the relative strong securities regulator versus the extremely weak insurance regulator, which sits in the Ministry of Finance. USAID/Armenia may want to weigh in on this matter, at some point, as the discussion and the development of the private pension fund industry evolve.

Retirement Age	63 men 58 women
Poverty Level	$20
Average Pension	$10
Pension expenditures as a pecent of GDP	2.8%
Estimated Pension Deficit in 2002	None
Dependency Ratio	0:.9
Contribution Rate	Employer: $10 plus 5% to 15% of wages, depending on salary; Employee 3% of wages, but no less than $10
Replacement Ratio	23%
Retirees	580,000
Workers	1 million
Contributors	400,000
GDP Growth	5.4% average from 1994-2000